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- **Level 2 Basics: Understanding Level 2 and Setting Up Your Level 2 Windows for Trading**

### Main Points:

- **Level 2** is a tool that's best used in combination with other indicators to fine-tune your daytrading entries and exits. Level 2 is a microscope that must be used with intraday chart patterns, time & sales and overall market direction for successful trading.
- The Level 2 window shows you all the **market participants** for a stock at a given moment in time, including the **relative strength** of buyers vs sellers.
- **Market participants** can be classified as: trades represented on **ECNs** (ISLD, INCA, ATTN, TNTO BTRD), **Instinet** (INCA), major **market makers** (GSCO SBSH MLCO MSCO), ARCA, and others. Knowing the difference in what it means when these people are representing their trades on Level 2 is important to success in daytrading. (eg HRZG frequently posts phony bid sizes, SBSH rarely headfakes, etc.). Following 'the ax' is an important skill to develop.
- The **Time & Sales** window (on the right, 'the tape') is the most important part of the Level 2 window to master, not the width and sizes as represented by various color bands.
- Level 2 bid and ask sizes alone will fake out the inexperienced trader. You cannot daytrade with the level 2 window alone.

## Understanding NASDAQ Level 2 Charts

Take a look at this level 2 chart for CHRX, trading 10.5 million shares as of 11:51am EST. A block of 40K has just gone off at the bid (bearish).

Inside Market (Yellow band)

Where the best bid and ask offers are displayed, in order of size, by market participant. Most important band to watch.

First Outside level (Green band)

A key band to pay attention to; a leading indicator to see where the mms think the price will go.

| CHRX                                             |          | Best Market |      | P       | T  | OK            |
|--------------------------------------------------|----------|-------------|------|---------|----|---------------|
| CHRX + 12 1/16 b 12 a 12 1/16 81 x 7 10.5M 11:51 |          |             |      |         |    |               |
| MMID                                             | Bid      | B.          | MMID | Ask     | A. |               |
| ISLD                                             | 12       | 81          | WARR | 12 1/16 | 7  | 12 1/16 200   |
| MASH                                             | 12       | 48          | ISLD | 12 1/8  | 33 | 12 1/16 1.00K |
| HRZG                                             | 12       | 43          | INCA | 12 1/8  | 30 | 12 1/16 400   |
| SHWD                                             | 12       | 28          | HRZG | 12 1/8  | 20 | 12 1/16 500K  |
| INCA                                             | 12       | 15          | SHWD | 12 1/8  | 10 | 12 1/16 300   |
| REDI                                             | 12       | 11          | LEGG | 12 1/8  | 10 | 12 1/16 300   |
| ARCA                                             | 12       | 5           | REDI | 12 1/8  | 6  | 12 1/16 1.00K |
| HMQT                                             | 12       | 3           | MASH | 12 1/8  | 5  | 12 1/16 500   |
| SLKC                                             | 12       | 2           | NITE | 12 1/8  | 1  | 12 1/16 40.00 |
| NITE                                             | 12       | 1           | FBCO | 12 1/8  | 1  | 12 1/16 1.00K |
| SELZ                                             | 11 15/16 | 10          | SELZ | 12 3/16 | 1  | 12 1/16 1.00K |
| JANY                                             | 11 15/16 | 1           | SBSH | 12 3/16 | 1  | 12 1/16 100   |

2nd 3rd Outside levels  
(Blue/Red bands)

Not very important, except to see where the ax fades to. This defines their "trade box" (more later).

BUYERS  
(Demand)

This column shows the price levels at which mm's are willing to pay for stock at this moment.

SELLERS  
(Supply)

Shows the price levels at which mm's are willing to sell the stock for at this moment.

TIME & SALES

The **most important part of the display**, T&S shows the size and price that stock changes hands at. It also shows the momentum of the stock as it scrolls by. (time is not displayed on this t&s ticker, just the price and quantity).

Note also that the "spread" between best bid and ask prices for this stock is 1/16, which is common for cheap stocks. The more expensive the stock, the wider the spread can get (from 1/4 point to 3/4 or so).

### Understanding What You're Really Seeing on Level 2:

- Level 2 shows the supply and demand, the transaction pace, the tape trend and the market participants in a stock all in one handy display.
- The numbers that are supposedly used to indicate the number of shares that a market participant (either a mm or via an ECN) is a **worthless indicator and can be misleading**. In the level 2 chart above, you see there's 8100 bids on ISLD, 4800 from MASH etc. (add 2 zeroes to the number to get the number in the bid or ask). Why is this? Market makers and traders on ecns can quickly cancel their orders, and mm's almost always use their "REFRESH" key to either keep buying or selling stock at a given price level. The T&S shows what's really happening.
- The width of the color bands (especially the first outside level, in green) can be a **very useful indicator**, it shows how many "new faces" are entering orders at each price level in the bid and ask columns in anticipation of a price move.
- The Time & Sales column shows the actual trades as they occur, and is the **most important piece of information I use when daytrading**. We'll devote at least 3 entire lessons to this critical skill of tape-reading momentum support and resistance levels, pivots and trends.
- An overall **clockwise motion indicates selling** in the Level 2 display (eg if buyers at 12 were to evaporate and 11 15/16 became the new best bid, 12 becoming the best ask).
- An overall **counterclockwise motion indicates buying** in Level 2 (eg if sellers at 12 1/16 are taken out and 12 1/16 now becomes the best bid, 12 1/8 rolls up to become best ask).
- We're usually in an out much faster than this clockwise motion shows us, **to succeed you need to intensely focus on the tape and the number of market participants in the yellow and green bands**.
- The more buyers you have lined up in the yellow bid column, the wider the "safety net" is to give you time to sell without losing much.

### Examples:

Remember our daytrading approach is always like a funnel; we make a very rapid mental checklist prior to entering a trade of these things:

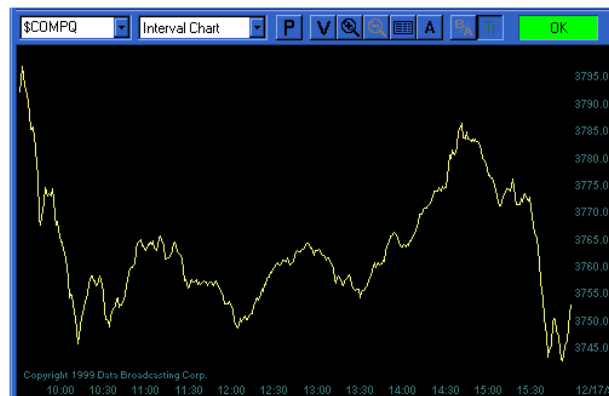
- **FIRST**: Overall Market Trend and Time-of-day, \$TRINQ, spoos/naz futures
- **SECOND**: Trend for Sector/sector leaders (eg \$GIN/\$SOX),
- **THIRD**: Review the 5-day support /resistance of the stock we're playing
- **FOURTH**: The intraday double bottoms/tops/trend of the stock (unless it's a news or bounce play), along with volume, stochastics/RSI/MACD,
- **FIFTH**, the width of the bid/ask levels in our Level 2
- **FINALLY**: Time & Sales, which we watch like a hawk prior to entering/exiting all trades.

**How long does this scan take? Less than 10 seconds for the first five steps above.** You patiently watch time and sales to see the true momentum of the stock prior to buying or selling it.

Your trading rig should be set up to make this like seeing the dashboard of your car. You know where things have come from and can anticipate "where they're going" with a fair amount of certainty very quickly.

Let's look at an example here, VRTY buying on a bottom bounce on volume strength:

**FIRST**: Checking the NASDAQ composite direction, see the naz bounced at 10:30 as usual (my 10:30 naz bounce on an open selling day rule). I was looking to buy stock on this second bottom bounce at 10:30. Also check the trinq, prem, spoos, naz futures if you like.



**SECOND**: Sector index or trend; Since VRTY was a special case (bottom bounce on oversold after bad news play) we didn't check the sector players. We usually do, however.

**5-Day CHART below:**



**Time to trade!** Elapsed time for this quick market scan: under 10 seconds. It's watching the time and sales window carefully that tells us when to pull the trigger.

through noon. In this chart, you can see a lot of selling pressure (profit taking) after the market closed and VRTY had its 6-point run.

red/white? What are the blocks (institutional buys/sells) telling us? What's the consensus of the players in this 5-minute to 15-minute timeframe? T&S tells us this, and more.

Once you're in, you watch t&s for any sign of weakness or selling. Is it "shaking", or are there really more sellers in the stock for the next few minutes? These are the questions we'll learn how to answer in future lessons.

I encourage you to use a similar setup for your level 2 windows: have the level 2, time and sales, thumbnail intraday chart and 5-day chart all together to give you a macro-to-micro look at the stock you're trading. Also have a single expanded intraday chart like the one above with all your technical indicators on it. It works!

### The Role of Using NASDAQ Level 2 to Help You Manage Your Trades

- Lots of pretty flashing colors. Billions of dollars are made and lost using this deceptively simple-looking device.
- **Remember that Level 2 can fake you out - it's the tape and TA that counts.**
- **A pros' skeptical look at this level 2 chart:** In this example, SBUX went to 5/8 and backpedaled all the way down to 24 1/16 before bouncing again. The yellow looks strong. But look at T&S: lots of trades going off at the 1/2, indicating selling. MWSE and HRZG are no-name market makers on the bid. Tough to tell what the traders on instinct (INCA) and ISLD will do. Meanwhile, solly (SBSH) and MONT are selling stock. In a battle of chippies (ARCA etc) vs big mm's the

| SBUX + 24 9/16 b 24 1/2 a 24 9/16 102 x1 600K 11:44 |         |      |      |          |      |  |         |       |  |
|-----------------------------------------------------|---------|------|------|----------|------|--|---------|-------|--|
| MMID                                                | Bid     | B... | MMID | Ask      | A... |  |         |       |  |
| MWSE                                                | 24 1/2  | 102  | MONT | 24 9/16  | 1    |  | 24 9/16 | 100   |  |
| INCA                                                | 24 1/2  | 20   | NITE | 24 5/8   | 9    |  | 24 9/16 | 300   |  |
| ISLD                                                | 24 1/2  | 13   | SBSH | 24 11/16 | 10   |  | 24 1/2  | 2.00R |  |
| FBCO                                                | 24 1/2  | 10   | SLKC | 24 11/16 | 1    |  | 24 1/2  | 1.00R |  |
| MADF                                                | 24 1/2  | 10   | PIPR | 24 3/4   | 1    |  | 24 9/16 | 100   |  |
| HRZG                                                | 24 1/2  | 6    | MLCO | 24 13/16 | 10   |  | 24 9/16 | 100   |  |
| PERT                                                | 24 1/2  | 1    | GSCO | 24 13/16 | 10   |  | 24 5/8  | 500   |  |
| SLKC                                                | 24 1/2  | 1    | MSCO | 24 13/16 | 10   |  | 24 1/2  | 300   |  |
| ARCA                                                | 24 1/2  | 1    | ISLD | 24 7/8   | 20   |  | 24 1/2  | 300   |  |
| BEST                                                | 24 7/16 | 10   | INCA | 24 7/8   | 10   |  | 24 1/2  | 200   |  |
| MASH                                                | 24 7/16 | 1    | DLJP | 24 7/8   | 10   |  | 24 1/2  | 100   |  |
| BRUT                                                | 24 3/8  | 1    | LEHM | 24 7/8   | 1    |  | 24 1/2  | 100   |  |
| SWCO                                                | 24 3/8  | 1    | MASH | 24 15/16 | 1    |  | 24 1/2  | 200   |  |
| MLCO                                                | 24 3/8  | 1    | MADF | 25       | 18   |  | 24 1/2  | 1.00R |  |
| ADAM                                                | 24 3/8  | 1    | FBCO | 25       | 10   |  | 24 1/2  | 500   |  |
| LEHM                                                | 24 3/8  | 1    | DAIN | 25       | 2    |  | 24 9/16 | 200   |  |
| RSSF                                                | 24 3/8  | 1    | HMQT | 25       | 1    |  | 24 9/16 | 200   |  |

Quick tips:

Again, the bid/ask sizes are pretty much worthless and misleading. Look at the tape: MONT has just sold 800 shares of SBUX even though his advertised ask size is for just 100 shares (a "1"). Refresh key in motion. He might have 100K shares to sell for all you know. This is level 2, not level 3; you don't know the true order size, and the mm sure as heck isn't going to let you know. They're a bit more useful for the

you're not) to big name and market makers win.

### **How do You manage your trades with Level 2?**

Don't get me wrong, I'd be very hesitant to daytrade without level 2; however it's just one of a handful of things I consider before I buy a stock. Hopefully the method outlined above will help you make a lot of money, as it has for me and other traders.

Go with the tape flow; use the relative width of the bid/ask bands to help you manage your trade exits. Level 2 primarily helps me decide whether to jump in on an ask level that's about to evaporate, to shadow a lead market maker as who's buying or selling in size, and to exit when the buyers are drying up and backing off the inside bid.

you know. They're a bit more useful for the ECNs, such as ISLD, but even those can get canceled in a quick second. Doesn't count.

**The "flow" of time and sales, and the volume going off at the ask price, is a much more useful indicator.**

Use the level 2 price level thicknesses to **help you decide how to bid for stock and how to offer it out on the ask.**

That's all the pretty color bands are for. Again, you never pay up two spreads by buying the ask and selling at the bid (unless you're in a panic to buy/sell, which should occur less than 20% of the time).

Follow one of the major market makers (GSCO MSCO MLCO SBSH) for a stock all day and trade like he does. You don't see a professional pay up retail and sell at wholesale, neither should you. He will have a "trade box" that he makes money in, buying at one level and selling at a higher one. Use level 2 to help you manage your trades like a market maker does.